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In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 804

JOSEPH KANE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 23–43) [1] is reported in 25 T. C. 1112. The *per curiam* opinion of the Court of Appeals (R. pp. 51–52) is reported in 238 F. 2d 624.

JURISDICTION

The judgments of the Court of Appeals (R. pp. 53–54) were entered on December 5, 1956. The petition for a writ of certiorari was filed on February 27, 1957. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

[1] Record references are to the appendix to the taxpayer's brief filed in the Court of Appeals.

QUESTION PRESENTED

Whether the record warrants the Tax Court's conclusion, affirmed by the court below, that income was realized by the taxpayer, as compensation for personal services, through the exercise of a stock option granted by taxpayer's employer to taxpayer's wife.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *.
>
> * * * * *
>
> (26 U. S. C. 1952 ed., Sec. 22.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> SEC. 29.22 (a)–1. *What Included in Gross Income.*—* * *
>
> If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall in-

clude in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. * * *

* * * * *

STATEMENT

In the Tax Court two cases with respect to the tax liability of Joseph Kane, hereinafter called the taxpayer, and a third case with respect to that of his wife, Rose Kane, were consolidated. (R. 22.) The facts as found by the Tax Court (R. 23–34) may be summarized as follows:

The taxpayer and his wife are residents of New York, N. Y. (R. 24.) Prior to the taxable years, the taxpayer lived in Cincinnati, Ohio, where he was a vice president of Gruen Watch Company, in charge of production. For the years 1940 to 1943, inclusive, he received salaries and bonuses aggregating from $20,000 to $34,000 a year. (R. 24–25.) On August 17, 1944, he entered into a written agreement to serve as assistant to the president of Bulova Watch Company, hereinafter called Bulova, in New York City. The agreement provided for the regular salary which the taxpayer would receive and also provided that he was to receive a percentage of Bulova's net profits. (R. 27–28.) On the same day that the taxpayer executed his contract with Bulova, his wife entered into a written agreement with Mr. Arde Bulova, chairman of the board of directors of Bulova, whereby she was

given the option to buy from him 1,000 shares of Bulova stock at the price of $37 per share, the option to be exercised as follows: 300 shares within the first year of the taxpayer's employment, 300 shares within the second year of his employment, and 400 shares within the third year of his employment. (R. 25, 29.)

The parties stipulated that the option price of $37 per share for the Bulova stock was in excess of the market price on the date the contracts were signed by the taxpayer and his wife, respectively. (R. 30.)

On July 24, 1945, before the taxpayer's wife exercised her right to purchase 300 shares of Bulova stock, there was a split of the stock on the basis of two new shares for one old share. (R. 30.) As a result of this stock split, the option agreement gave the taxpayer's wife the right to purchase a maximum amount of 2,000 shares at $18.50 per share, 600 shares during the first and second years of the taxpayer's employment, and 800 shares during the third year. (R. 31.)

The taxpayer's wife exercised her option to purchase Bulova stock on the dates and in the amounts shown in the following table at a substantial reduction below the market price (R. 31):

Date option exercised	Number of shares acquired	Cost	Market value	Excess of market value over cost
Dec. 27, 1945	600	$11,100	$22,200	$11,200
Aug. 6, 1946	600	11,100	30,750	19,650
July 21, 1947	800	14,800	27,000	12,200
Total	2,000	37,000	80,050	43,050

She apparently used her own funds with which to purchase the Bulova stock. (R. 31, 32.) She kept

the stock in her own safe deposit box and received the dividends on that stock. (R. 32.)

The taxpayer received aggregate salary and bonus payments from Bulova in 1945, 1946, and 1947, in the approximate amounts of $34,000, $44,000 and $55,000, respectively. (R. 32.)

The Commissioner determined deficiencies against the taxpayer for the years 1945, 1946, and 1947 in the aggregate amount of about $32,000, on the ground that he realized income in the amounts of $11,100, $19,650, and $12,200, respectively, for the years in question through the exercise of the option by his wife, to the extent of the difference between the option price and the market price. (R. 24, 32–33.)

For the year 1945 the taxpayer's wife reported, as ordinary income, gain from the exercise of a stock option in the amount of $11,100. She did not report any gain from the exercise of a stock option in her income tax returns for 1946 or 1947. The Commissioner determined a deficiency against her for the year 1947[2] on the ground that she realized income in the amount of $12,200 upon the exercise of an option to buy 800 shares of Bulova stock at a price $12,200 less than the market price. (R. 33.) In the Tax Court, the Commissioner made it clear that the inconsistent deficiency asserted against the taxpayer's wife was only for the purpose of protecting the revenue in the event that it should ultimately be decided

[2] At the time when the Commissioner determined a deficiency for 1947, the statute of limitations had run for the year 1946. The taxpayer's wife has filed a claim for refund as to the year 1945, action in which has been deferred pending the outcome of this case.

that the income was not taxable to the husband. (R. 34.)

The Tax Court found that the option to purchase Bulova stock was given to the taxpayer's wife as an inducement to him to accept the position of assistant to the president of Bulova in 1944 and to continue in the employ of the company and that the option was intended to provide additional compensation to the taxpayer in each year in which it was exercised. The Tax Court also found that the option was not intended to provide the taxpayer's wife with a proprietary interest in the company; and that in each of the years 1945, 1946 and 1947, the taxpayer realized additional compensation for his services in the amount of the excess of the market value of the Bulova stock over the option price paid for the acquisition of stock. (R. 34.) The Tax Court sustained the Commissioner's determination of deficiencies against the taxpayer and reversed the Commissioner's determination against the taxpayer's wife. (R. 43.)

The Court of Appeals affirmed the decisions of the Tax Court in a *per curiam* opinion. (R. pp. 51–52.)

ARGUMENT

1. The decision of the court below is correct. Section 22 (a) of the Internal Revenue Code of 1939, *supra*, p. 2, provides in part that "gross income" includes income derived from "salaries, wages, or compensation for personal service, * * * of whatever kind and in whatever form paid." Section 29.22 (a)–1 of Treasury Regulations 111, *supra*, pp. 2-3, provides, in part, that if property is transferred by an

employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of compensation for services rendered or to be rendered.

Whether the option in this case, although exercisable by the wife, was intended by all parties concerned as a means of affording additional compensation to the taxpayer, as the Commissioner contends, or whether it was given to the wife for reasons completely independent of the taxpayer's employment, as the taxpayer contends, presents a question of fact which has been resolved against the taxpayer by both courts below. Although the option was given to the employee's wife, and not directly to the employee, the two agreements (the employee's contract and that of his wife) were executed on the same day. There were references in the wife's agreement to the employee's agreement, and also an indication that the option depended upon his continued employment. From these facts the Tax Court could reasonably infer that the two agreements were part of the same transaction, and that the stock option was intended as part of the employee's compensation and was given to his wife with his assent. While there was some conflicting evidence on this, it was the function of the Tax Court to weigh the evidence, draw inferences, and pass on the credibility of the witnesses. *Elmhurst Cemetery Co.* v. *Commissioner,* 300 U. S. 37, 40; *Helvering* v.

Kehoe, 309 U. S. 277, 279; *Helvering* v. *Nat. Grocery Co.,* 304 U. S. 282, 294–295; cf. *United States* v. *Yellow Cab Co.,* 338 U. S. 338, 341. On the record, the Tax Court's conclusion may not reasonably be said to be clearly erroneous. Furthermore, the court below affirmed the decision of the Tax Court (R. pp. 51–52) and this Court has frequently observed that concurrent findings of both courts below are entitled to finality here. *Comstock* v. *Group of Investors,* 335 U. S. 211, 214, and cases cited.

The taxpayer's petition seeks to raise, for the first time in this Court, alternative questions concerning the amount of income which should be taxed to him. (Pet. 2–3, Questions III and IV.) Since these issues were not raised in the Court of Appeals, they will ordinarily not be considered by this Court. *Helvering* v. *Tex-Penn Co.,* 300 U. S. 481; *Helvering* v. *Minnesota Tea Co.,* 296 U. S. 378. At all events, the finding of the Tax Court to the effect that the compensation intended to be conferred on the taxpayer was the (R. 43) "economic benefit to be derived from the exercises of the option," rather than from the grant of the option, is conclusive against the taxpayer's contention (Pet. 13–14) that the Tax Court should not have held that the measure of the income was to be determined by the spread between option price and actual value of the stock on the date when the option was exercised. *Commissioner* v. *LoBue,* 351 U. S. 243, rehearing denied, 352 U. S. 859; *Commissioner* v. *Smith,* 324 U. S. 177, rehearing denied, 324 U. S. 695.

2. There is no conflict of decisions. In *Bogardus* v. *Commissioner*, 302 U. S. 34 (Pet. 10), the cash bonus was held to be a gratuity and not intended as compensation; the factual setting of this case is altogether different and the conclusion of both courts below that compensation for personal services was intended by the employer makes this an altogether different case. In *McNamara* v. *Commissioner*, 210 F. 2d 505 (C. A. 7th) (Pet. 11), the Court of Appeals reversed the Tax Court and held that the stock option was intended to be income to the employee when granted and not when exercised, as the Tax Court had decided. Assuming that the *McNamara* case was correctly decided, the facts there are so different from this case that no conflict exists. Thus, in that case the option was exercisable or transferable without regard to the taxpayer's employment and the option price was less than the value of the stock at the time when the option was granted. In the present case the exact opposite is true. In *Commissioner* v. *Reece*, 233 F. 2d 30 (C. A. 1st) (Pet. 12), the taxpayer made an absolute assignment of the right to receive patent royalties to his wife, whereas in this case the taxpayer's compensation for personal services is involved; this Court decided many years ago that a taxpayer could not avoid the income tax on his earnings through an assignment to his wife. *Lucas* v. *Earl*, 281 U. S. 111. *Palmer* v. *Commissioner*, 302 U. S. 63 (Pet. 13–14), deals with the question whether the issuance of stock-purchase rights should be treated as a distribution of corporate earnings, taxable as a dividend, and obviously has no direct application here.

CONCLUSION

The decision of the court below is clearly correct and there is no conflict of decisions. The petition for a writ of certiorari should be denied.

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MARCH 1957.

U. S. GOVERNMENT PRINTING OFFICE: 1957

Office-Supreme Court
FILED
MAR 30 19
JOHN T. FEY, C

No. 804

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

In respondent's memorandum in opposition to the granting of the writ, respondent makes two statements that are inaccurate. On page 4, he states that the parties stipulated that the option price of $37.00 per share for the Bulova stock was in excess of the market price on the date the contracts were signed by the taxpayer and his wife; whereas, the stipulation states that the option price was in excess of the market price *at the time the option was granted,* (p. 20, of Petition for Writ) which was not the date the option agreement was signed. See page 7 of Petition for Writ of Certiorari.

The respondent further states: "On July 24, 1945, before the taxpayer's wife exercised her right to purchase 300 shares of Bulova stock, there was a split-up of the stock on the basis of 2 new shares for 1 old share. As a result of this stock split, the option agreement gave taxpayer's wife the right to purchase a maximum amount of

2,000 shares at $18.50 per share, 600 shares during the first and second years of the taxpayer's employment and 800 shares during the third year."

This statement is inaccurate. No such provision is contained in the option agreement. Mr. Bulova allowed the taxpayer's wife to make such purchases because he felt this was the right thing to do despite the fact that the option agreement was silent with regard to stock dividends or split-ups either as to quantity of stock to be acquired or the price to be paid.

It is noteworthy that in his statement the respondent makes no reference to the fact that Rose Kane was never an employee of the Bulova Watch Co. Inc. or of Arde Bulova and that the petitioner was not an employee of Arde Bulova nor was he an employee of the Bulova Watch Co., Inc. at the time the option was granted to Rose Kane—and furthermore, that it was stipulated that neither Arde Bulova nor the Bulova Watch Co. Inc. had ever issued prior to March 31, 1947 an option to acquire Bulova Watch Co. Inc. stock to any employee of either.

Respondent argues since the Tax Court and the U. S. Court of Appeals for the Second Circuit decided that the option granted to Rose Kane was intended as compensation to Joseph Kane and that this conclusion was a finding of fact, that this Court should not pass on the correctness of such conclusion by granting to petitioner the requested Writ of Certiorari.

In reply, petitioner cites this Court's granting of Writs of Certiorari in the cases of *Commissioner of Internal Revenue* v. *LoBue,* 351 U. S. 243, and *Bogardus* v. *Commissioner of Internal Revenue,* 302 U. S. 34, although in each case the Board of Tax Appeals or the Tax Court of the United States, and the U. S. Court of Appeals were in agreement and the cases involved factual questions similar to those involved in the instant case.

In support of the decisions of the court below, the respondent states that "there were references in the wife's agreement to the employee's agreement, and also an indication that the option depended upon his continued employment."

Here again the respondent errs, for the option agreement makes no reference to the employee's agreement.

In fact, the option agreement with Mrs. Kane, reduced to writing on August 17, 1944, states at the outset: "As you know, we have been seeking to employ your husband, Joseph Kane, but he is hesitating in accepting employment in our Company because you do not desire to move your home to New York from Cincinnati, where you now reside."

These words certainly cannot be construed to support respondent's statement that the wife's agreement made references to the employee's agreement or that the option depended on petitioner's continued employment.

The fact that the Tax Court from alleged conflicting evidence arrived at a given conclusion does not mean that the Supreme Court may not set aside its findings of fact as contrary to the evidence.

The respondent asserts that the petitioner did not raise Questions III and IV in the courts below and that this is the first time that the issues are being raised.

The respondent is in error. In petitioner's reply brief filed with the U. S. Court of Appeals, there is the following argument on page 10: "Thus, even if it be assumed, though strenuously denied by Joseph Kane, that Joseph Kane was intended to be the initial recipient of the option, he did not hold the property right after August 17, 1944. The value accruing to said property right after that date should no longer be chargeable to Joseph Kane, particularly when the funds necessary to take advantage of the property right belonged to and the subsequent benefits of said property right were received by Rose Kane."

Further, on page 11 of petitioner's reply brief, there is stated: "It requires no citation beyond the U. S. Supreme Court ruling in *Palmer* v. *Commissioner of Internal Revenue,* 302 U. S. 63, 69, to establish that a purchase of property by an individual from an unrelated party does not result in gain or loss to the purchaser * * * * *".

Thus it is evident that this question was raised before the court below. In any case, the denial that any income arose to petitioner from the exercise of the option by Rose Kane would embrace the issue set forth in Question III.

The respondent is likewise in error when he asserts that Question IV was not raised in the courts below.

That the petitioner raised the question of amended Regulations in the Tax Court is evident from that Court's opinion when it stated, in part: "It is pointed out that the respondent does not contend that this amendment to Regulations 111, Section 29.22(a)-1 contained in T. D. 5507, dated April 12, 1946, 1946-1 CB 18, and elaborated upon in I. T. 3795, 1946-1, CB-15, apply to the stock option, which is involved in these proceedings. The respondent recognizes that the stock option granted by Arde Bulova was given on August 17, 1944, and accordingly it is a stock option granted prior to February 26, 1945." The issue involved in Question IV was also presented in oral argument to the court immediately below.

As a matter of public policy and to resolve an important question of statutory construction, this Court should take jurisdiction and grant petitioner's application for a Writ of Certiorari.

It is of great importance to note that the respondent does not challenge the correctness of the statements made by petitioner in support of Questions III and IV.

CONCLUSION

For the foregoing reasons, petitioner prays that a Writ of Certiorari be granted.

Respectfully,

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